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ABSTRACT

Although California has the world's seventh largest economy, the state has one of the nation's highest childhood poverty rates and one of the worst income inequality gaps. This report advocates the use of a state earned income credit (EIC) for low-income working families to reward work and to offset the payroll and sales taxes that disproportionately burden low-income workers. The report argues that with a budget surplus of at least five billion dollars for the current year (2000-2001) and the prediction of a continued strong economy, California has more than sufficient resources to establish a state EIC. Further, the report maintains that since the majority of poor children have a parent who works, the EIC is an effective strategy to help working parents provide the basics for their children. The report describes the establishment of the federal EIC and how it works for families, discusses the persistence of child poverty in California, outlines the establishment of state EIC in 12 other states, and delineates by county the percent of California tax filers receiving the federal EIC for the tax year 1997. The report concludes by asserting that the need for long-term policies that support working families remains compelling in California and that the passage of a state EIC would affirm values of individual responsibility and fairness, while investing in children's future through their working parents. (KB)

A Children Now Report

Where Credit's Due:

What A State Earned Income Credit Means for California's Children

CHILDREN NOW

Where Credit's Due:

What A State Earned Income Credit Means for California's Children

Introduction

The future looks bright for California. Home to the expanding world of high technology and the growing media and entertainment industries, California has the world's seventh largest economy. State government will enjoy a budget surplus of possibly $5 billion or more in 2000-2001.[1] Yet, California has a greater number of families who are hungry or worry about feeding their children than most states.[2] Our childhood poverty rate is one of the country's highest.[3] Our income inequality gap is one of the country's worst.[4] And yet, workforce participation is high; the state's unemployment rate, as of February 2000, was 4.6%, the lowest since December 1969.[5]

There is a proven public policy that can help fill in this gap for working families. The Earned Income Credit (EIC) is a tax credit for low-income working families. Available only to those who work, the EIC is designed to reward work and to offset the payroll and sales taxes that disproportionately burden low-income workers. Established in 1975, the federal EIC has received bi-partisan support over the last two and a half decades. Since the establishment of the federal credit, twelve states have created supplemental state EICs. The National Center for Children in Poverty cited the EIC as one of the most effective measures against childhood poverty, calculating that the national young childhood poverty rate would have been 24% higher in 1997 were it not for the federal EIC.[6]

With a budget surplus of possibly $5 billion or more this year and economists predicting a continued strong economy, California has more than sufficient resources to establish a state EIC. With one quarter of California children living in poverty, a state EIC would successfully address one of the state's most critical public problems in California-our disturbingly high child poverty rate. Since the majority of poor children have a parent who works, the EIC is an effective strategy to help working parents provide at least the basics for their children. A state EIC helps families who are working hard to help themselves.

The Federal Earned Income Tax Credit: A Credit for Working Families

Congress established the EIC in 1975 to compensate for the inequitable burden of payroll taxes carried by low-wage workers. Unlike income taxes that increase as income rises, payroll taxes disproportionately burden low-wage workers as they are set at the same percentage regardless of income, up to an income cap (in 1999, the maximum amount of wages subjected to Social Security taxes was $72,600).[7]

The National Center for Children in Poverty cited the EIC as one of the most effective measures against childhood poverty.

During the Reagan, Bush and Clinton Administrations, the EIC was significantly expanded. In 1998, this tax credit lifted 4.8 million people out of poverty, 2.6 million of whom were children.[8] In total, 19.8 million low-income workers and children benefited from the credit that year.[9]

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[1] An official estimate will be disclosed by the California Governor's Office in mid-May.
[2] Assessing the New Federalism, a project of The Urban Institute, *Snapshots of America's Families* (Washington, DC: UI, January 1999).
[3] Current Population Survey "Unpublished Table 25 Poverty Status by State and Ten Large Metropolitan Areas in 1998" (Washington, DC: CPS, March 1998).
[4] Center on Budget and Policy Priorities (CBPP) and the Economic Policy Institute (EPI), *Pulling Apart, a State-by-State Income Analysis* (Washington, DC: CBPP and EPI, January 2000).
[5] Employment Development Department (EDD), "Table A Employment and Unemployment in California, Seasonally Adjusted Data" (Sacramento, CA: EDD, 2000).
[6] National Center for Children in Poverty (NCCP), *Young Children In Poverty: A Statistical Update*, June 1999 Edition (New York, NY: NCCP, 1999).
[7] Department of the Treasury, Internal Revenue Service *Publication 15 Circular E, Employer's Tax Guide (Including 1999 Wage Withholding and Advance Earned Income Credit Payment Tables)* (Washington, DC: IRS, 2000).
[8] CBPP, *Earned Income Credit Outreach Kit 2000* (Washington, DC: CBPP, 2000) citing the U.S. Census Bureau, Current Population Survey 1999.
[9] CBPP, *A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty 1999 Edition* (Washington, DC: CBPP, 1999).

How the Federal EIC Works for Families

Available only to low-income working families and individuals, the amount of the credit received is based on earnings. For tax year 1999, families with two or more children received an increasing credit up through annual earnings of $9,500; the benefit remains constant through earnings of $12,000; families earning above $12,000 received a decreasing benefit up to the eligibility cap of $30,500.

The median income of families with children receiving the federal EIC was about $12,000 in 1999.[10] In 1998, families with one child received an average federal credit of $1,447; for a family with two or more children, the average federal credit was $2,262.[11] Families are eligible whether one or both parents participate in the workforce, making it easier for one parent to stay at home with the children. Individuals or couples without children are also eligible for the federal EIC, although their credit amount is significantly lower.

Families use the EIC to pay for both day-to-day living costs as well as for special expenses. A recent study in Chicago found that EIC recipients are most likely to use their refunds to pay bills. The families with the lowest incomes are especially likely to use the EIC for food, utilities and rent payments. More than half of all beneficiaries in the study used their federal credits for expenses related to "social mobility" such as paying for tuition or purchasing books, as an alternative to student loans, or for transportation costs. With help from the EIC, families were able to move to better neighborhoods and pay for better child care. Ninety percent of recipients said that they would not have been able to make such payments at that time were it not for the EIC.[12]

Persistent Poverty in Spite of Work

In California, the child poverty rate is 24% for children from birth to 17 years. The youngest children are the most likely to live in poverty, with a poverty rate among children from birth to age four of 28.6%.[13] Child poverty is concentrated in the rural areas of the state and is especially high in the Central Valley. In 1995, the counties of Fresno, Merced and Tulare had young child poverty rates of 42.2%, 38.4% and 44.7% respectively.[14] Los Angeles County also had one of the highest rates, with 39.6% of young children living in poverty.

Poverty has a profound influence on a child's life. Children growing up in poverty are at greater risk of having poor health, being held back a grade, dropping out of school, becoming pregnant as teenagers and committing or being victims of a crime. Poverty in a child's earliest years has the most pronounced effect on their future, and yet young children are the most likely of all age groups to live in poverty.[15]

In California, one child out of four lives in poverty; for children from birth to age four, nearly 30 percent live in poverty.

While California's economy has improved dramatically since the recession of the early 1990s, the state's child poverty rate remains stubbornly high. From its highest point of 28.6% of all children living in poverty in 1993, the rate has come down only slightly to 24.1% in 1998.[16] Yet, parents are working: the state's unemployment rate, as of February 2000, was 4.6%, the lowest since December 1969.

Absent a concerted effort by the public and private sectors, California's high child poverty rate is unlikely to improve significantly. California has the fifth largest income gap in the nation and low wages are considered a

[10] Correspondence with Nick Johnson, Center on Budget and Policy Priorities, April 2000.
[11] CBPP, *A Hand Up*, ibid.
[12] Timothy M. Smeeding, Katherine E. Ross, and Michael O'Connor, *The Economic Impact of the Earned Income Tax Credit (EITC): Consumption, Savings, and Debt*, Center for Policy Research Working Paper Series Number 13, Center for Policy Research, The Maxwell School, Syracuse, NY: Syracuse University, October 1997.
[13] Children Now, *California Report Card 1999* (Oakland, CA: Children Now, 1999).
[14] ibid.
[15] Jeanne Brooks-Gunn and Greg Duncan, "The Effects of Poverty on Children" in The David and Lucile Packard Foundation, *The Future of Children*, Vol. 7, No. 2, Summer/Fall 1997 (Los Altos, CA: The David and Lucile Packard Foundation, 1997).
[16] Children Now, *California: The State of Our Children* 1998 (Oakland, CA: Children Now, 1998) and U.S. Census Bureau, Current Population Survey 1999.

major contributor to the gap.[17] Full-time work at the minimum wage ($5.75 per hour) yields an annual income of just $11,500, or 64% of the federal poverty level for a family of four. The lowest fifth of California earners have an annual income only slightly above this level, at $12,200. The future does not seem much brighter as half of the ten occupations with the greatest projected growth in the state pay an hourly wage of $10 or less. These occupations include cashiers, salespersons, guards, receptionists and office clerks.[18]

Poverty in a child's earliest years has the most pronounced effect on their future, and yet young children are the most likely of all age groups to live in poverty.

An analysis by the California Budget Project recently concluded that families in California need an hourly wage ranging between almost $11 and nearly $18, depending on family size and the number of earners in a family, to provide the very basics, including shelter, food, child care and transportation.[19] California's high cost of living makes this state particularly difficult for low-income working families. California has seven of the eight most expensive metropolitan housing markets in the nation, in which at least 67% of renters pay more than half of their income on rent.[20]

Earned Income Credit in Other States

As of April 2000, twelve states had established their own EIC. With one exception (Minnesota), all of the states elected to model their programs after the federal EIC. A state EIC that follows the federal system simplifies administration, tracking and outreach to families. In addition, states can also take advantage of recent legislation that helps reduce fraudulent claims. Most states set their EICs at a percentage of the federal EIC, making it easy to calculate; Wisconsin, however, offers a range depending on family size.[21] Colorado added a fiscal contingency to its EIC: if the state suffers a recession, the EIC will be suspended until the state's budget picture improves.

A key difference among the state credits is whether or not they are refundable. A refundable credit allows families to receive the benefit even if their income is so low that they owe no state taxes. A non-refundable credit may only be used to reduce the amount of taxes owed, which precludes the lowest income families from benefiting.

llinois, Iowa, Oregon and Rhode Island offer solely a non-refundable EIC. Eight states-Colorado, Kansas, Maryland, Massachusetts, Minnesota, New York, Vermont and Wisconsin-offer refundable credits. Maryland residents choose between a refundable or non-refundable credit; the non-refundable credit is set at 50% of the federal EIC and the refundable credit is set at 10% of the federal EIC (scheduled to increase to 15% in 2001).

Tough times will continue for working parents in California: half of the ten occupations with the greatest projected growth pay $10 per hour or less.

Reducing Filing Errors

Recent federal legislation helps to ensure that the EIC is not claimed erroneously. The new rules expand the power of the IRS to recapture EIC overpayments from workers' wages or public benefits, create additional penalties for fraud and negligence related to EIC claims and add penalties for tax preparers who fail to fulfill "due diligence" requirements in connection to erroneous EIC claims.[22]

The State of New York has added further safeguards against errors with its state EIC. New York's measures include: checking dependents' social security num-

[17] CBPP and EPI, ibid.
[18] California Employment Development Department (EDD), *California - Occupations With Greatest Growth*, 1996-2006 (Sacramento, CA: EDD, 1999).
[19] California Budget Project, *Making Ends Meet, How Much Does It Cost to Raise a Family in California?* (Sacramento, CA: CBP, October 1999).
[20] CBPP, *In Search of Shelter* (Washington, DC: CBPP, 1997).
[21] CBPP, *A Hand Up*, ibid.
[22] CBPP, *Earned Income Credit Outreach Kit 2000* (Washington, DC: CBPP, 2000).

States with Earned Income Credits

State	Refundable	Percentage of the Federal EIC
Colorado	Yes	8.5%
Illinois	No	5%
Iowa	No	6.5%
Kansas	Yes	10%
Maryland	Yes	10% - will increase to 15% in 2001
Massachusetts	Yes	10% - will increase to 15% in 2001
Minnesota	Yes	Average state credit is 29%; the percentage varies depending on income. It is not modeled after the federal EIC.
New York	Yes	20% - will increase to 25% in 2001
Oregon	No	5%
Rhode Island	No	26.5%
Vermont	Yes	25%
Wisconsin	Yes	4%-43%, depending on the number of children in a family

Source: Center on Budget and Policy Priorities.

bers to verify they have not been claimed twice, cross-checking EIC claims with W-2 forms and Schedule C forms, and identifying first-time state tax form filers, who are among those most likely to make mistakes.

A California Earned Income Credit

In 1998 (for tax year 1997), 2.4 million families and individuals received a federal EIC benefit in California, roughly 17% of those who filed taxes. In Los Angeles County, 22% of income tax filers received the federal EIC; with its higher than average participation, Los Angeles residents accounted for 35% of all EIC beneficiaries in the state. The Central Valley is another area with high participation. In Fresno, the largest Central Valley county, nearly one in three tax filers (29%) received an EIC benefit. The neighboring counties of Kern, Kings, Madera, Merced and Tulare also had high percentages of EIC recipients, ranging from 27% in Kern and Kings counties to 34% in Tulare county.[23]

If the state of California were to set a state EIC at 15% of the federal EIC, a family with one child would receive a maximum credit of $347 and a family with more than one child would receive a maximum credit of $572.[24] These amounts may seem insignificant to people earning higher incomes, but for a low-income working family, several hundred dollars can make a critical difference. For example, for the family with one child, $347 pays for nearly one month of child care, one half month's rent in some areas of the state, or needed clothes and school books.

In California, the poorest families pay proportionately more in sales and excise taxes: families with incomes less than $23,000 pay just over 7% of their income on sales and excise taxes compared to families with incomes up to $146,000 who pay 2.5% in sales and excise taxes.[25] In the same way that the federal EIC reduces the disproportionate burden of payroll taxes on low-income families, a state EIC would help reduce the burden of recessive state sales and excise taxes.

In addition, middle and higher income families in California are offered tax benefits not generally available to poorer families including mortgage interest deductions, tax exempt contributions to retirement funds, employer contributions to pension plans, employer contributions to health

[23] Data compiled from the Internal Revenue Service's e-file demographics (website: www.irs.ustreas.gov/prod/elec_svs/demogrfx.htm) and the California Department of Finance, *California County Profiles* (Sacramento: DOF, February 1999).
[24] Calculated by Children Now using maximum federal EIC benefit and assuming a California EIC would be set at 15% of the federal credit.
[25] California Budget Project, *Strategies to Reward Work: How Can a State Earned Income Tax Credit Assist California's Working Poor?* (Sacramento, CA: CBP, October 1999). Examples of excise taxes include cigarette and gasoline taxes.

California Recipients of the Federal EIC for Tax Year 1997

By County

County	# of Taxfilers Receiving Federal EIC	% of Taxfilers Receiving EIC	% of Children (0-17) Living in Poverty
Alameda	65,823	11%	17.3%
Alpine	66	14%	28.5%
Amador	1,554	12%	13.2%
Butte	13,807	18%	26.7%
Calaveras	2,053	13%	17.1%
Colusa	901	22%	21.3%
Contra Costa	34,728	9%	12.3%
Del Norte	1,794	21%	26.7%
El Dorado	7,114	11%	11.6%
Fresno	79,827	29%	36.3%
Glenn	2,223	23%	26.0%
Humboldt	9,055	18%	24.2%
Imperial	21,387	39%	33.4%
Inyo	1,314	16%	18.9%
Kern	58,423	27%	27.8%
Kings	9,993	27%	28.6%
Lake	4,024	20%	29.1%
Lassen	1,525	15%	17.5%
Los Angeles	774,521	22%	33.7%
Madera	10,861	28%	27.6%
Marin	7,605	6%	8.6%
Mariposa	938	15%	19.0%
Mendocino	6,650	19%	24.9%
Merced	19,797	29%	35.6%
Modoc	588	18%	26.9%
Mono	79	18%	12.7%
Monterey	31,160	21%	22.1%
Napa	5,185	10%	13.0%
Nevada	4,552	12%	13.6%
Orange	149,081	14%	16.4%
Placer	9,330	9%	10.3%
Plumas	1,126	14%	19.3%
Riverside	110,629	21%	19.7%
Sacramento	70,416	15%	24.5%
San Benito	3,633	19%	15.4%
San Bernardino	119,806	21%	22.9%
San Diego	173,987	15%	22.7%
San Francisco	40,437	10%	20.6%
San Joaquin	37,551	19%	27.2%
San Luis Obispo	12,661	13%	16.7%
San Mateo	25,371	7%	9.6%
Santa Barbara	24,573	15%	19.3%
Santa Clara	64,321	8%	13.4%
Santa Cruz	18,943	16%	17.8%
Shasta	11,688	18%	24.0%
Sierra	153	11%	10.6%
Siskiyou	3,134	18%	25.8%
Solano	19,773	13%	13.5%
Sonoma	20,436	10%	13.3%
Stanislaus	33,198	21%	24.6%
Sutter	221	17%	22.7%
Tehama	3,881	22%	27.7%
Trinity	484	22%	25.6%
Tulare	41,154	34%	37.3%
Tuolumne	2,970	14%	17.6%
Ventura	43,958	14%	13.8%
Yolo	9,248	15%	20.4%
Yuba	4,942	24%	34.0%

Source: Taxfiler information from IRS website, www.irs.ustreas.gov/prod/elec_svs/demografix.htm; child poverty information from Children Now, *California County Data Book 1999*.

In California, the poorest families now pay proportionately more in sales and excise taxes: families with incomes less than $23,000 pay just over 7% of their income on sales and excise taxes compared to families with incomes up to $146,000 who pay 2.5% in sales and excise taxes.

plans, exclusions on capital gains on inherited property and the sale of a residence.[26]

The estimated cost for a California EIC equal to 15% of the federal credit is almost $700 million, considerably less than other tax credits that already benefit higher earning families. For example, in 1998, the state of California spent more than $3 billion in mortgage interest expenses, almost $2 billion in tax credits for employers who contribute to a health plan and $750 million in capital gains exclusions on the sale of a home.[27] All these credits typically benefit wealthier Californians and not the working poor. A state EIC would be the state's only tax credit designed for those who work but earn the least wages.

Conclusion

While California enjoys unprecedented wealth, it is important to remember that not everyone is benefiting from the economy. California's childhood poverty rate is one the country's highest and our income inequality gap is one of the country's worst. At the same time, workforce participation is high. Given current wage trends, the need for long-term policies that support working families remains compelling.

The additional several hundred dollars a working family's credit provides is nearly enough to pay for one month of child care or to improve a child's quality of care. It can help pay for needed car repairs to ensure safe transportation or help people into a safer neighborhood. These are expenses some families take for granted, but for the more than two million Californians who received the federal EIC, these costs often are left unmet, or put parents in the untenable position of choosing between car repairs and paying an electric bill, between a doctor's visit and buying school supplies.

A state EIC would be the state's only tax credit designed for those who work but earn the least wages.

The legislature has a golden opportunity to enable more working families and their children to share in California's bright future. The Earned Income Credit—a working family's credit—has received broad bi-partisan support since its inception. Only available to working individuals, it supports those who work at low-wage jobs and helps parents provide for their children. Passage of a state EIC would affirm our common values of individual responsibility and fairness, while investing in children's future through their working parents.

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[26] Jack Hailey, Senate Office of Research, unpublished data December 1999.
[27] Senate Office of Research, unpublished data December 1999.

About Children Now:

Children Now is a nonprofit, independent voice for children, working to translate the nation's commitment to children and families into action. Children Now combines policy expertise and up-to-date information on children with communication strategies to reach parents, lawmakers, citizens, business, media and community leaders to generate positive change on behalf of children. With particular concern for those who are poor or at risk, Children Now is committed to improving conditions for all children. Founded in 1988, Children Now is a national organization with special depth in California.

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